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A Class Action Securities Fraud Claim Brought under State Law by Holders of Securities Is Preempted by a Federal Act Purporting to Encompass Claims Brought by Purchasers and Sellers: *Merill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*

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A Class Action Securities Fraud Claim Brought
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Sellers: *Merrill Lynch, Pierce, Fenner & Smith, Inc.*
v. Dabit

SECURITIES LAW — CLASS ACTIONS — PREEMPTION OF STATE-LAW CLAIMS — The United States Supreme Court held that the Securities Litigation Uniform Standards Act language “in connection with the purchase or sale of . . . a security” encompasses the holding of securities and results in the preemption of state law.

Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503 (2006).

Respondent Shadi Dabit filed a class action against Merrill Lynch, Pierce, Fenner & Smith, Inc., alleging a breach of fiduciary duty and covenant of good faith and fair dealing.¹ The class included Dabit, a former Merrill Lynch broker, and all other brokers who purchased certain stocks for themselves or clients between December 1, 1999, and December 31, 2000, while employed at Merrill Lynch.² Dabit contended that fraudulent misrepresentations by Merrill Lynch caused the class to hold on to overvalued securities, resulting in investment losses and lost clientele.³

Instead of advancing the claim under federal securities laws, Dabit invoked diversity jurisdiction and brought suit under Oklahoma state law.⁴ Merrill Lynch moved to dismiss the complaint, arguing that Title I of the Securities Litigation Uniform Stan-

1. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1507 (2006).

2. *Merrill Lynch*, 126 S. Ct. at 1507.

3. *Id.* Dabit alleged that research analysts — at the direction of management — distributed overly confident appraisals of stock values, upon which the brokers based their own investment decisions and advice to their investor clients. *Id.* As a result, the brokers and clients held their stocks beyond the point where they would have sold had they known the true stock value. *Id.* When the truth was revealed, the stocks’ values fell significantly. *Id.*

4. *Id.*

dards Act of 1998 (SLUSA)⁵ preempted the state law action.⁶ The district court declared that the complaint alleged both wrongfully induced purchasing and wrongfully induced holding, only the former of which was preempted by SLUSA.⁷ After dismissal with leave to amend, Dabit filed an amended complaint, aimed at avoiding SLUSA preemption, which referenced a class of brokers who had suffered damages from the continued ownership of securities as opposed to the purchase of securities.⁸ The case was transferred to the United States District Court for the Southern District of New York, where Merrill Lynch filed a second motion to dismiss.⁹ Senior Judge Pollock granted the motion because Dabit's allegations fell "squarely within SLUSA's ambit."¹⁰

Dabit appealed to the United States Court of Appeals for the Second Circuit.¹¹ He argued that SLUSA did not preempt the state law action because his complaint did not allege fraudulent behavior with regard to the purchase or sale of securities.¹² The issue was whether the *holding* of securities fell within the preemption realm of SLUSA, when the language of the Act referred only to the "purchase or sale of" securities.¹³ Although the circuit court stated that the phrase "in connection with the purchase or sale of" must be interpreted loosely, it remarked that its reach was not unlimited.¹⁴ With reasonable limits in mind, the court adopted the constraint on private federal securities actions that the United States Supreme Court had ratified in *Blue Chip Stamps v. Manor Drug Stores*,¹⁵ which applied only to those who "are themselves purchasers or sellers of the securities in ques-

5. 15 U.S.C. § 78bb(f)(1)(A) (2000).

6. *Merrill Lynch*, 126 S. Ct. at 1508. Merrill Lynch also argued that the claim was not cognizable under Oklahoma law, but the court was unimpressed by this argument. *Id.*

7. *Id.*

8. *Id.*

9. *Id.* Several other suits based on allegations similar to Dabit's had been filed; all were transferred to the United States District Court for the Southern District of New York for consolidated pretrial proceedings. *Id.*

10. *Id.* (quoting *In re Merrill Lynch & Co.*, 2003 WL 1872820, at *1 (S.D.N.Y. Apr. 10, 2003)).

11. *Dabit v. Merrill Lynch, Fenner & Smith, Inc.*, 395 F.3d 25 (2d Cir. 2005), *vacated*, 126 S. Ct. 1503 (2006).

12. *Dabit*, 395 F.3d at 28. Dabit contended that SLUSA's preemption provision did not apply because the class alleged fraud that caused members to keep overvalued stocks, resulting in "holding" damages. *Id.* The class also sought unearned commissions for clientele that departed after the publication of Merrill Lynch's alleged overvaluation. *Id.*

13. *Id.* (citing 15 U.S.C. § 78bb(f)(1)(A) (2000)).

14. *Id.* at 37 (citing 15 U.S.C. § 78bb(f)(1)(A)).

15. 421 U.S. 723 (1975).

tion.”¹⁶ Using the *Blue Chip* limitation, Dabit’s allegation of fraud relating to the holding of overvalued securities fell outside the preemption dominion of SLUSA,¹⁷ which allowed the class action to proceed.¹⁸ The Supreme Court granted certiorari to address whether the alleged fraud was “in connection with the purchase or sale” of securities when the damages alleged came not from buying or selling securities, but from holding them too long.¹⁹

Justice Stevens delivered the opinion of the Court.²⁰ As the Second Circuit had stated, to trigger SLUSA’s preemption provision: (1) the principal suit must be “a covered class action”;²¹ (2) the action must relate to “a covered security”;²² (3) the charge must be based on state or local law; and (4) the defendant must have omitted or misrepresented a material fact or used a manipulative or deceptive device or contrivance “in connection with the purchase or sale of” the security at issue.²³ The Court asserted that the issue was whether the supposed fraud was truly “in connection with the purchase or sale of” securities, when Dabit was allegedly damaged as a holder.²⁴ Dabit argued that the relevant language should be interpreted narrowly, like the purchaser-seller limitation the Court ratified in *Blue Chip*.²⁵ The Court rejected this argument, holding that with respect to preemption by SLUSA, the distinction between purchaser, seller, and holder was irrelevant.²⁶

To arrive at its decision, the Court first looked at the acts promulgated to protect the market for nationally traded securities.²⁷

16. *Dabit*, 395 F.3d at 37.

17. *Id.* at 44.

18. *Id.* at 47. The appellate court affirmed the district court judgment in part because some of the class members were considered purchasers, which warranted preemption under SLUSA. *Id.* at 46. Dabit was permitted to file a second amended complaint excluding them. *Id.*

19. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1512 (2006).

20. *Merrill Lynch*, 126 S. Ct. at 1506 (all members joined except Alito, J., who took no part in the consideration or decision of the case).

21. *Dabit*, 395 F.3d at 33. A “covered class action” — in relevant part — is one in which the damage-seeking class is comprised of more than fifty people. *Merrill Lynch*, 126 S. Ct. at 1512 (citing 15 U.S.C. § 78bb(f)(5)(B) (2000)).

22. *Dabit*, 395 F.3d at 33. A “covered security” is nationally traded and listed on a national exchange. *Merrill Lynch*, 126 S. Ct. at 1412 (citing 15 U.S.C. § 78bb(f)(5)(E)).

23. *Dabit*, 395 F.3d at 33 (citing *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1342 (11th Cir. 2002)).

24. *Merrill Lynch*, 126 S. Ct. at 1512.

25. *Id.* (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 749 (1975)).

26. *Id.* at 1515.

27. *Id.* at 1510. After the collapse of the stock market in 1929 and the Great Depression, Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934. *Id.* at 1509.

Securities and Exchange Commission (SEC) Rule 10b-5²⁸ outlawed fraudulent practices "in connection with the purchase or sale of any security."²⁹ Later, the Court of Appeals for the Second Circuit in *Birnbaum v. Newport Steel Corp.*³⁰ limited the reach of the private right of action under Rule 10b-5 so that it could be invoked only "by a purchaser or seller of securities to remedy fraud associated with his or her own sale or purchase of securities."³¹

Many lower court decisions adopted the inflexible *Birnbaum* limitation, while other cases endorsed a broader reading of the "in connection with" language.³² These inconsistent interpretations set the stage for the Court to make a decisive ruling on whether a Rule 10b-5 claim was available to any party who suffered harm for its violation, or only to those who were purchasers or sellers.³³

In *Blue Chip*,³⁴ the Court chose to limit the private remedy for a Rule 10b-5 violation to the purchasers and sellers of the security in question.³⁵ The rationale of the *Blue Chip* decision, like *Birnbaum*, was based on the idea of curbing vexatious litigation.³⁶

28. 17 C.F.R. § 240.10b-5 (2006). This regulation provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id. Rule 10b-5 was born in 1942 out of § 10(b) of the Securities Exchange Act of 1934. *Merrill Lynch*, 126 S. Ct. at 1509 (citing 15 U.S.C. § 78j(b) (2000)).

29. *Merrill Lynch*, 126 S. Ct. at 1509-10 (quoting 17 C.F.R. § 240.10b-5). The private right of action under Rule 10b-5 is not express; it was court-created in *Kardon v. Nat'l Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946), and endorsed by the Court in *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971). *Merrill Lynch*, 126 S. Ct. at 1509.

30. 193 F.2d 461 (2d Cir. 1952).

31. *Merrill Lynch*, 126 S. Ct. at 1509-10 (citing *Birnbaum*, 193 F.2d 461).

32. *Id.* at 1510 (citing *Bankers Life*, 404 U.S. at 12-13 (interpreting the coverage of Rule 10b-5 broadly, prohibiting "deceptive practices touching [a victim's] sale of securities as an investor.")).

33. *Id.* at 1510.

34. 421 U.S. 723 (1975).

35. *Merrill Lynch*, 126 S. Ct. at 1510.

36. *Id.* Justice Stevens wrote:

The main policy consideration tipping the scales in favor of precedent was the widespread recognition that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." Even weak cases brought under the Rule may have substantial settlement value . . . because "[t]he very pendency of the lawsuit may frustrate or delay normal business activity." Cabining the private cause of ac-

Similar policy considerations prompted Congress to enact the Private Securities Litigation Reform Act of 1995³⁷ ("Reform Act").³⁸ While Rule 10b-5 confers a right of action for fraud in securities trading, the Reform Act limits the abuse of class actions under the Rule by imposing heightened requirements and related sanctions.³⁹ The consequence of the Reform Act was unexpected.⁴⁰ Plaintiffs started bringing their securities fraud claims under state law to avoid the burdens of the Reform Act.⁴¹ Faced with the frustration of the Reform Act's objectives, Congress enacted SLUSA,⁴² which preempts state law with federal law (i.e., it imposes the requirements of the Reform Act) for covered state-law class action securities fraud claims.⁴³

Dabit argued that his cause of action was not preempted by SLUSA because the class did not allege fraud "in connection with the purchase or sale of" securities; rather, it alleged fraud in connection with the holding of securities.⁴⁴ The argument was based on the decision in *Blue Chip*, where the Court narrowly interpreted the same language with respect to litigation under Rule 10b-5.⁴⁵ The Court rejected Dabit's argument, stating that "[t]he

tion by means of the purchaser-seller limitation would, in the Court's view, minimize these ill effects.

Id. at 1510 (citations omitted).

37. 15 U.S.C. §§ 77z-1, 78u-4 (1998).

38. *Merrill Lynch*, 126 S. Ct. at 1511. The courts had been seeing an influx of class action securities litigation characterized by "nuisance filings, [the] targeting of deep-pocket defendants, [and] vexatious discovery requests." *Id.* at 1510-11.

39. *Id.* Title I of the Act requires heightened pleading requirements for actions brought pursuant to Rule 10b-5 and/or § 10(b) of the Securities Exchange Act of 1934. *Id.* The Reform Act imposes penalties for frivolous claims, limits recoverable damages, and authorizes a stay of discovery pending the resolution of a dismissal motion. *Id.*

40. *Id.* at 1511.

41. *Id.*

42. 15 U.S.C. § 78bb(f)(1)(A) (2000). The pertinent language of the Act is as follows:

CLASS ACTION LIMITATIONS.-- No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging--

(A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or

(B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

15 U.S.C. § 78bb(f)(1) (emphasis added).

43. *Merrill Lynch*, 126 S. Ct. at 1511.

44. *Id.* at 1512 (quoting 15 U.S.C. § 78bb(f)(1)(A)).

45. *Id.* This is the interpretation the Second Circuit used in *Dabit v. Merrill Lynch, Fenner & Smith, Inc.*, 395 F.3d 25 (2d Cir. 2005), vacated, 126 S. Ct. 1503 (2006). *Merrill Lynch*, 126 S. Ct. at 1512.

background, the text, and the purpose of SLUSA's preemption provision all support [a] broader interpretation."⁴⁶

The foundation of Dabit's argument — SLUSA's background — crumbled when Justice Stevens rejected Dabit's reasoning, given the Court's assumption that the holding in *Blue Chip* had stemmed from the text of Rule 10b-5.⁴⁷ Justice Stevens explained that the ruling in *Blue Chip* was based not on formulating a definition for the "in connection with the purchase or sale of" phrase, but instead on policy considerations necessitating a defined scope of the private right of action under Rule 10b-5.⁴⁸ He noted further that historically the Court had interpreted the phrase broadly, rejecting narrow interpretations in *SEC v. Zandford*⁴⁹ and in *Superintendent of Insurance of New York v. Bankers Life & Casualty Co.*⁵⁰ Justice Stevens stated that the identity of the plaintiff was not controlling, as long as the alleged fraud coincided with a securities transaction.⁵¹

Turning to the text of the Act, Justice Stevens pointed out that Congress must have been aware of the phrase's broad construction when it wrote "in connection with the purchase or sale" into the key terms of SLUSA.⁵² According to the general presumption, when an interpretation by the judiciary becomes established within the meaning of a statute, Congress' subsequent use of identical language shows its intent to integrate the Court's interpretation as well.⁵³ Not only was the language identical, the SLUSA provision appeared in the same statute as § 10(b).⁵⁴ Utilizing another rule of statutory construction, the Court noted that, in instances where identical language is used in different parts of the

46. *Merrill Lynch*, 126 S. Ct. at 1507.

47. *Id.* at 1512.

48. *Id.* Justice Stevens noted that any uncertainty regarding the "in connection with" language had been settled by the time SLUSA was enacted. *Id.* (citing *United States v. O'Hagan*, 521 U.S. 642, 656 (1997) (holding that the "in connection with" element is satisfied when fraud is used in the buying or selling of securities); *Holmes v. Sec. Investor Prot. Corp.*, 503 U.S. 258, 285 (1992) (O'Connor, J., concurring) (holding that the plaintiff need not be a purchaser or seller to have standing for a RICO claim asserting the violation of fraud in the sale of securities); *United States v. Naftalin*, 441 U.S. 768, 774 (1979) (holding that the element of § 17(a) of the Securities Act of 1933 that requires fraud in relation to the purchaser is met when the fraud was committed against a broker, who suffered in turn)).

49. 535 U.S. 813 (2002).

50. *Merrill Lynch*, 126 S. Ct. at 1513 (citing *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 (1971)).

51. *Id.*

52. *Id.*

53. *Id.* (quoting *Bragdon v. Abbott*, 524 U.S. 624, 645 (1998)).

54. *Id.*

same statute, the general presumption is that it carries the same meaning.⁵⁵

Justice Stevens next turned to the purpose behind the enactment of SLUSA.⁵⁶ He stated that the narrow reading of the statute proposed by Dabit “would undercut the effectiveness of the 1995 Reform Act and . . . run contrary to SLUSA’s stated purpose” — to prevent plaintiffs from bringing class action suits in state courts to avoid the burdens of the Reform Act.⁵⁷ Further, a narrow construction would interfere with Congress’ intent to have national standards governing class action lawsuits for nationally traded securities.⁵⁸

Before concluding, Justice Stevens made clear that the Court had not forgotten the general rule that “Congress does not cavalierly preempt state-law causes of action.”⁵⁹ Keeping that in mind, the rule was less forceful in this instance than in others because SLUSA did not, in reality, preempt a state cause of action; it merely denied plaintiffs the ability to use a class action in certain instances.⁶⁰ Further, Congress had refrained from casting too wide a net by tailoring exceptions to SLUSA’s coverage.⁶¹ Finally, the Court stated that SLUSA did not preempt “a historically entrenched state-law remedy.”⁶² Justice Stevens concluded by declaring that, since there was no relevant distinction between a class action securities fraud claim brought by *holders* or by *purchasers* or *sellers*, Dabit’s complaint fell into the realm of SLUSA, and his state-law claim was preempted by federal law — here the Reform Act.⁶³

55. *Merrill Lynch*, 126 S. Ct. at 1513.

56. *Id.* at 1513-14.

57. *Id.* at 1513. Referring to a narrow construction, the Court noted that it would be odd to exempt class actions of *holders* from SLUSA’s reach when they threaten “vexatious litigation.” *Id.* at 1514.

58. *Id.* at 1514 (citing H.R. REP. NO. 105-640, at 10 (1998) (stating the need to make the federal court the sole venue for class action securities fraud claims)).

59. *Id.* (citing *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 485 (1996)).

60. *Merrill Lynch*, 126 S. Ct. at 1514. For example, SLUSA permitted the enforcement of a state-law securities fraud claim, as long as the group was comprised of less than fifty plaintiffs. *Id.*

61. *Id.* SLUSA exempts: (1) state-law class actions where the issuer of the security is incorporated; (2) claims by a state agency or pension plan; (3) actions pursuant to contracts between issuers and indenture trustees; and (4) derivative actions brought by shareholders on behalf of a corporation. *Id.* (citing 15 U.S.C. § 78bb(f)(3)(A)-(C), (f)(5)(C) (2000)).

62. *Id.* at 1514-15. Before the passage of the Reform Act, class action securities claims were primarily brought in federal court. *Id.* (citing H.R. CONF. REP. NO. 105-803, at 14 (1998)).

63. *Id.* at 1515.

Section 10(b) of the Securities and Exchange Act of 1934 did not declare any conduct unlawful.⁶⁴ Instead, it gave the SEC the power to make rules to stop deceptive practices in the buying and selling of securities.⁶⁵ Rule 10b-5 was promulgated pursuant to § 10(b) of the Act,⁶⁶ and generally forbids fraud in connection with the purchase or sale of any security.⁶⁷ Regarding 10b-5, two commentators have noted that “it is difficult to think of another instance in the entire *corpus juris* in which the interaction of the legislative, administrative rulemaking, and judicial processes has produced so much from so little. What is more remarkable is that the whole development was unplanned.”⁶⁸

One branch of the “judicial oak which [had] grown from little more than a legislative acorn”⁶⁹ was the interpretation of the phrase “in connection with the purchase or sale of securities.”⁷⁰ In 1952, the United States Court of Appeals for the Second Circuit dealt with the phrase’s meaning in *Birnbaum*.⁷¹

64. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir. 1952).

65. *Birnbaum*, 193 F.2d at 463.

66. *Id.*

67. 17 C.F.R. § 240.10b-5 (2006).

68. LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 936 (5th ed. 2004). Loss recalls a detailed account of the administrative enactment of 10b-5, as given by M. Freeman:

It was one day in the year [1942], I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, “I have just been on the telephone with Paul Rowen,” who was then the S.E.C. Regional Administrator in Boston, “and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his shareholders at \$4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be \$2.00 a share for this coming year. Is there anything we can do about it?” So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where “in connection with the purchase or sale” should be, and we decided that it should be at the end.

We called the Commission and we got on the calendar, and I don’t remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, “Well,” he said, “we are against fraud, aren’t we?” That is how it happened.

Id. at 937-38 (citing A.B.A. SEC. OF CORP., BANKING & BUS. LAW, *Conference on the Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 921-23 (1967)).

69. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) (Rehnquist, C.J., referring to the legal developments that have sprung from the enactment of Rule 10b-5).

70. *Birnbaum*, 193 F.2d at 462-63.

71. *Id.* at 463.

The defendants in *Birnbaum*, C. Russell Feldman, the Newport Steel Corporation, and the Wilport Company, were sued by the stockholders of the Newport Steel Corporation for a violation of Rule 10b-5.⁷² Feldman owned forty percent of the Newport Steel common stock, giving him voting control, and was president of the company and chairman of its board of directors.⁷³ From June to August, 1950, Newport Steel had been engaged in merger talks with the Follansbee Steel Corporation.⁷⁴ Under its proposed terms, the merger would have been highly lucrative to Newport stockholders.⁷⁵

In an unexpected move, Feldman rejected the Follansbee offer and sold his Newport shares for twice the market value to Wilport Company, an alliance of ten raw steel users; Feldman then resigned as president.⁷⁶ The sale gave Wilport control of Newport Steel during a period of low supply.⁷⁷ The plaintiffs alleged fraud under Rule 10b-5.⁷⁸ In response, the defendants argued that the plaintiffs were not purchasers or sellers under the rule, and thus lacked standing to bring suit.⁷⁹

The Second Circuit agreed with the defendants, admitting that the rule “may have been somewhat loosely drawn,” but that its scope and meaning were ascertainable when viewed in reference to the SEC regulatory scheme and under the purpose for which Rule 10b-5 had been adopted.⁸⁰ The court explained that, before Rule 10b-5 was enacted, § 17(a)⁸¹ of the 1933 Act and § 15(c)⁸² of

72. *Id.* at 462. Newport Steel manufactured steel for sale to the manufacturers of finished products. *Id.*

73. *Id.* Other defendants were Stamm, Aheim, Rohr, Lorenzen, Shaffer, and Ballantyne, all directors of Newport who were under the control of Feldman. *Id.*

74. *Id.*

75. *Birnbaum*, 193 F.2d at 462.

76. *Id.* The directors of Wilport, also defendants, took the place of Feldman and the directors under his control following the sale. *Id.*

77. *Id.*

78. *Id.* The complaint detailed an August 3, 1950 letter from Feldman, stating to the Newport shareholders that negotiations with Follansbee were suspended due to the “uncertain international situation.” *Id.* Gibson, who took over as president of Newport, reported the stock sale to the plaintiffs in a September 14, 1950 letter, but failed to state the price or the fact that Newport would become a subsidiary of Wilport. *Id.*

79. *Id.*

80. *Birnbaum*, 193 F.2d at 463.

81. 15 U.S.C. § 77q(a) (2000). The Act states:

(a) Use of interstate commerce for purpose of fraud or deceit

It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly

the 1934 Act were the only proscriptions against fraudulent securities sales or purchases.⁸³ Section 17(a) banned the deception of securities purchasers, and § 15(c) covered fraud by dealers or brokers in over-the-counter markets.⁸⁴ The sections did not cover the fraudulent buying of securities, so the SEC adopted Rule 10b-5.⁸⁵ Strictly interpreting the SEC's agenda, the Second Circuit held that Rule 10b-5 protected only defrauded buyers and sellers of securities.⁸⁶ This rule, referred to as the *Birnbaum* rule, governed the right to sue under Rule 10b-5 and generally became accepted at the appellate level.⁸⁷

Twenty-three years later, the Supreme Court of the United States narrowly upheld the *Birnbaum* rule in *Blue Chip*.⁸⁸ In this case, the Blue Chip Stamp Co. ("Old Blue Chip") had been sued by the United States in a civil antitrust action.⁸⁹ The suit was terminated by a consent decree whereby Old Blue Chip was to reorganize by merging into Blue Chip Stamps, a newly formed corporation.⁹⁰ Under the consent decree, Blue Chip Stamps was to offer a substantial amount of its common stock to non-shareholder retailers who had used the stamp service in the past.⁹¹ The plan was executed, a prospectus was issued to the offerees, and over

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the *purchaser*.

15 U.S.C. § 77q(a) (emphasis added).

82. 15 U.S.C. § 78o(c) (2000).

83. *Birnbaum*, 193 F.2d at 463.

84. *Id.*

85. *Id.* The court noted that the SEC was attempting to make the prohibitions of § 17(a) applicable to buyers. *Id.* A comparison of the language of § 17(a) and Rule 10b-5 is illustrative of this intention. *Id.*

86. *Id.* at 464. Responding to the plaintiffs' argument that a narrow interpretation would not effectuate the SEC's goal via the Act of 1934 to "protect investors from exploitation by corporate insiders," the court stated that legislative history and the purpose behind Rule 10b-5 were not sufficiently persuasive to show that 10b-5 was enacted to reach that end. *Id.*

87. LOSS & SELIGMAN, *supra* note 68, at 1041. The Seventh Circuit was the only circuit that rejected the rule in *Eason v. Gen. Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973). LOSS & SELIGMAN, *supra* note 68, at 1041.

88. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

89. *Blue Chip*, 421 U.S. at 725.

90. *Id.* at 725-26.

91. *Id.* at 726. The shares of the majority holders of Old Blue Chip stock were reduced under the reorganization. *Id.* The offerings to non-holders were proportional to past stamp usage. *Id.*

fifty percent of the shares offered were bought.⁹² The plaintiff, an offeree who chose not to buy, sued Blue Chip Stamps under Rule 10b-5, alleging that the prospectus was overly pessimistic and materially affected his decision not to buy.⁹³

The issue before the Court was whether the plaintiff could sue under Rule 10b-5 when the plaintiff had neither purchased nor sold the securities in the prospectus.⁹⁴ Justice Rehnquist delivered the majority opinion of the Supreme Court.⁹⁵ He began by briefly tracing the development of federal securities laws through the enactment of Rule 10b-5 and issued a reminder that the private right to action under the Rule was court created.⁹⁶

Based on the circuit courts' longstanding acceptance of the *Birnbaum* rule, coupled with the fact that Congress had never rejected it, Justice Rehnquist declared strong support for *Birnbaum* in the Supreme Court.⁹⁷ Next, Justice Rehnquist turned to the congressional scheme of securities regulation, emphasizing that "[w]hen Congress wished to provide a remedy to those who neither purchase[d] nor [sold] securities, it had little trouble in doing so expressly."⁹⁸

Further, if the Court implied a private right of action for a plaintiff who neither bought nor sold, a conflict would arise with

92. *Id.*

93. *Id.* at 726-27. The nine retailers who owned ninety percent of Blue Chip Stamps were also named as defendants. *Id.* at 725. The plaintiff alleged that the prospectus was overly pessimistic in order to keep the retailers from buying so that the public could purchase the offerings later at higher prices. *Id.* at 726-27. The plaintiff sought \$21.4 million in damages for the lost chance to buy, \$25 million in exemplary damages, and the opportunity to buy the stocks at the price offered in the prospectus. *Id.*

94. *Blue Chip*, 421 U.S. at 727. The case had been dismissed by the district court, *Manor Drug Stores v. Blue Chip Stamps*, 339 F. Supp. 35 (C.D. Cal. 1971). The Ninth Circuit reversed, 492 F.2d 136 (9th Cir. 1973), based on the majority's view that the plaintiff's rights as a potential beneficiary under the consent decree fell under an exception to *Birnbaum* that protected non-buyers and non-sellers who owned contractual rights to buy or sell. *Manor Drug*, 492 F.2d at 142.

95. *Blue Chip*, 421 U.S. at 725. (Powell, J., filed a concurring opinion, in which Stewart & Marshall, JJ., joined; Blackmun, J., filed a dissenting opinion, in which Douglas & Brennan, JJ., joined).

96. *Id.* at 729-30. The private right of action under Rule 10b-5 is not express; it was created by the United States District Court for the Eastern District of Pennsylvania in *Kardon v. Nat'l Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946), and endorsed by the Supreme Court in *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971). *Blue Chip*, 421 U.S. at 729-30. Justice Rehnquist noted that, if Congress had expressly created a private right of action under 10b-5, the Court would not have modified its bounds. *Id.* at 748-49.

97. *Blue Chip*, 421 U.S. at 733.

98. *Id.* at 734 (alteration in original). Section 16(b) of the 1934 Act granted an express private right of action against corporate insiders engaged in securities fraud. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir. 1952).

the 1934 Act, which limited damages to those actually suffered by the plaintiff.⁹⁹ Also, if the Court allowed a suit without a purchase or sale, it would render useless the provision of the 1934 Act that made violative trades voidable,¹⁰⁰ which had justified an implied private right of action under Rule 10b-5 in the first place.¹⁰¹ Further, Congress had already limited plaintiff standing in the private causes of action it expressly authorized to purchasers and sellers, so it would have been inconsistent to expand the plaintiff class beyond that scope for a court-created private right of action.¹⁰² That said, Justice Rehnquist admitted that an exploration of congressional intent was not dispositive with regard to the bounds of Rule 10b-5, considering its growth by way of decisional law since 1942.¹⁰³ Thus, the policy considerations behind Rule 10b-5 warranted examination.¹⁰⁴

The three classes of would-be plaintiffs that were barred by the *Birnbaum* rule included: (1) potential purchasers who chose not to buy based on fraudulent representation or omission; (2) shareholders who chose not to sell for the same reason(s); and (3) shareholders who suffered a loss from corporate activities or insider activities that violated Rule 10b-5.¹⁰⁵ Members of the second and third classes could potentially bring a derivative action,¹⁰⁶ but the first class was completely barred.¹⁰⁷ For this reason, the *Birnbaum* rule was commonly called an "arbitrary restriction."¹⁰⁸

However, Justice Rehnquist concluded that, despite these disadvantages, on balance the rule remained advantageous.¹⁰⁹ In an

99. *Blue Chip*, 421 U.S. at 734-35. In § 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a) (2000), private remedies were limited to "actual damages." *Blue Chip*, 421 U.S. at 734-35. This impliedly required an ascertainable number of trades in order to compute a remedy. *Id.* If recovery were allowed by a plaintiff who neither bought nor sold, damage amounts would be hypothetical based on the plaintiff's estimate. *Id.*

100. 15 U.S.C. § 78cc(b).

101. *Blue Chip*, 421 U.S. at 735.

102. *Id.* at 735-36 (referring to the 1933 and 1934 Acts).

103. *Id.* at 737 ("When we deal with private actions under Rule 10b-5, we deal with a judicial oak that has grown from little more than a legislative acorn. Such growth may be quite consistent with the congressional enactment and with the role of the federal judiciary in interpreting it . . .").

104. *Id.*

105. *Id.* at 737-38.

106. *Blue Chip*, 421 U.S. at 738. A derivative action is "[a] suit by a beneficiary of a fiduciary to enforce a right belonging to the fiduciary; esp., a suit asserted by a shareholder on the corporation's behalf against a third party (usu. a corporate officer) because of the corporation's failure to take some action against the third party." BLACK'S LAW DICTIONARY 475 (8th ed. 2004).

107. *Blue Chip*, 421 U.S. at 738.

108. *Id.* at 738-39.

109. *Id.* at 739.

explanatory footnote, Justice Rehnquist stated that the disadvantages of the rule were alleviated to some extent because remedies were obtainable for non-purchasers and non-sellers under state law.¹¹⁰ Justice Rehnquist noted that the primary policy consideration in favor of the *Birnbaum* rule was the “danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5.”¹¹¹ The two-pronged basis for the aforementioned danger was the potential for strike suits and the difficulty of proving facts where there was no transaction.¹¹²

The majority in *Blue Chip* explained that in a strike suit, a plaintiff with an objectively small chance of winning nevertheless enjoyed a settlement value out of proportion to his potential for success because he could not be stopped by summary judgment.¹¹³ Intertwined with the difficulties associated with strike suits was the potential for abuse of discovery under the Federal Rules of Civil Procedure.¹¹⁴ Also, a Rule 10b-5 claim without the *Birnbaum* rule turned on whose testimony the jury decided to believe.¹¹⁵ The court would have almost no power to enjoin a case, no matter how weak it was, other than through settlement.¹¹⁶ Justice Rehnquist admitted that there was no general rule to interpret the law so that a defendant could more easily obtain summary judgment.¹¹⁷ However, the potential for strike suits in securities fraud claims made the *Birnbaum* rule and the possibility of excluding *some* legitimate plaintiffs the lesser of evils.¹¹⁸

The second basis for fear of vexatious litigation absent the *Birnbaum* rule was the idea that the trier of fact would be faced with “rather hazy issues of historical fact[,] the proof of which [would depend] almost entirely on oral testimony.”¹¹⁹ Justice Rehnquist drew a distinction between the tort of misrepresentation and de-

110. *Id.* at 739 n.9.

111. *Id.* at 740.

112. *Blue Chip*, 421 U.S. at 740-43.

113. *Id.* at 740. Justice Rehnquist noted that Congress adopted a provision aimed at curbing strike suits in the expressly conferred private causes of action granted in the 1933 Act. *Id.* at 741 (citing *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 548-49 (1949)). According to Justice Rehnquist, that fact alone warranted opposition to strike suits in *Blue Chip* where the private right was judicially implied. *Id.* at 740.

114. *Id.* at 741.

115. *Id.* at 742.

116. *Id.* The *Birnbaum* rule, however, was a standing requirement that could be verified using objective documentation. *Id.*

117. *Blue Chip*, 421 U.S. at 742-43.

118. *Id.* at 743.

119. *Id.* (alteration in original).

ceit versus a Rule 10b-5 claim.¹²⁰ The rules of standing in a deceit claim had been peeled back over time, moving away from limitations like the *Birnbaum* rule.¹²¹ Justice Rehnquist explained that the *Birnbaum* rule could not be relaxed because the state of the modern commercial transaction caused the dissemination of stock advice to millions of potential investors.¹²² Under the rule, only plaintiffs who have dealt in the security to which the fraud relates could bring suit; that was the value of *Birnbaum*.¹²³ Thus, the majority concluded that the *Birnbaum* rule should be followed based on policy considerations, the intent of Congress, and historical support of the rule.¹²⁴ After admitting potential mitigating circumstances,¹²⁵ the Court decreed that an exception to *Birnbaum* would not be made for fear of leaving the rule "open to endless case-by-case erosion."¹²⁶

120. *Id.* at 744-45.

121. *Id.* at 744. The privity limitation was eliminated, as well as the requirement that the misrepresentation be of fact instead of opinion. *Id.* Also, a misrepresentation and deceit cause of action could be brought for wrongly induced refusal to buy or sell. *Id.*

122. *Blue Chip*, 421 U.S. at 745-46.

123. *Id.* at 747. Justice Rehnquist's explanation was as follows:

But in the absence of the *Birnbaum* rule, it would be sufficient for a plaintiff to prove that he had failed to purchase or sell stock by reason of a defendant's violation of Rule 10b-5. The manner in which the defendant's violation caused the plaintiff to fail to act could be as a result of the reading of a prospectus, as respondent claims here, but it could just as easily come as a result of a claimed reading of information contained in the financial pages of a local newspaper. Plaintiff's proof would not be that he purchased or sold stock, a fact which would be capable of documentary verification in most situations, but instead that he decided not to purchase or sell stock. Plaintiff's entire testimony could be dependent upon uncorroborated oral evidence of many of the crucial elements of his claim, and still be sufficient to go to the jury. The jury would not even have the benefit of weighing the plaintiff's version against the defendant's version, since the elements to which the plaintiff would testify would be in many cases totally unknown and unknowable to the defendant. The very real risk in permitting those in respondent's position to sue under Rule 10b-5 is that the door will be open to recovery of substantial damages on the part of one who offers only his own testimony to prove that he ever consulted a prospectus of the issuer, that he paid any attention to it, or that the representations contained in it damaged him.

Id. at 745-46.

124. *Id.* at 749.

125. *Id.* at 755. The plaintiff corporation in *Blue Chip* had a prior connection to the defendants, was an intended beneficiary under the consent agreement, was significantly smaller (as a corporation) than a class attributing fraud to a newspaper's financial pages, and its manager(s) had probably in fact read the allegedly fraudulent prospectus. *Id.* at 754.

126. *Id.* at 755. Applying the facts of the case to the majority holding, the plaintiff was barred from suing under Rule 10b-5 because it was not a purchaser or seller. *Id.*

Justice Blackmun, joined by Justice Douglas and Justice Brennan, dissented.¹²⁷ Justice Blackmun protested the Court's endorsement of an "arbitrary principle of standing."¹²⁸ Responding to the majority rationale, the dissent argued three points, beginning with the majority's reliance on inclusive legislative history.¹²⁹ The dissent also claimed that reliance on the *Birnbaum* holding was misplaced because it was decided under dissimilar circumstances, and that the majority employed hypothetical considerations of policy based on the difference between meritorious and meritless claims under Rule 10b-5.¹³⁰

According to the dissent, an anomaly resulted from refusing to acknowledge the plaintiff as party to the sale when the purpose of the scheme was to prevent the plaintiff from ever becoming a buyer.¹³¹ Instead of defining sale as "a single, individualized act transferring property from one party to another," Justice Blackmun defined it as a "generalized event of public disposal of property through advertisement, auction, or some other market mechanism."¹³² With this definition in mind, Justice Blackmun presented his own formulation of the proper test for Rule 10b-5 standing where the plaintiff was required to show only a "logical nexus between the alleged fraud and the purchase or sale of a security."¹³³

Armed with the majority's holding in *Blue Chip*, the plaintiff class in *Merrill Lynch* argued that SLUSA did not preempt state law.¹³⁴ The Court in *Blue Chip* had decided that the phrase "in connection with the purchase or sale of" meant that the plaintiff must either be a purchaser or seller (not a holder) in the allegedly fraudulent transaction.¹³⁵ SLUSA employed the same phrase, so Dabit argued that a holder class must not be subject to its pre-

127. *Blue Chip*, 421 U.S. at 761 (Blackmun, J., dissenting).

128. *Id.*

129. *Id.* at 761-62.

130. *Id.* at 762. The dissent pointed to a collection of literature since *Birnbaum* that had been critical of the rule. *Id.* at 769. Regarding its policy rationale, the dissent explained that the fears of the majority regarding litigation difficulties under 10b-5 without the *Birnbaum* limitation were overblown, "as if all these [had been] unknown to lawsuits taking place in America's courthouses everyday." *Id.* Further, if *Birnbaum* were overruled, the dissent argued, courts would develop rational standards of proof to impede meritless claims. *Id.* at 771.

131. *Id.* at 765.

132. *Blue Chip*, 421 U.S. at 764 (Blackmun, J., dissenting).

133. *Id.* at 770. Using this test, the complaint in *Blue Chip* would not have been dismissed. *Id.* at 771.

134. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1512 (2006).

135. *Blue Chip*, 421 U.S. at 755.

emption power.¹³⁶ However, the Court explained that it had relied on policy considerations, not the meaning of the "in connection with" phrase, in deciding *Blue Chip*.¹³⁷ Thus, the Court held that SLUSA preempted holder claims as well as those of purchaser and seller.¹³⁸

It is important to understand the major implication of the decision in *Merrill Lynch*. Suppose hypothetical plaintiff Carl Fox and forty-nine other similarly situated shareholders (hereinafter "Fox") each own five-hundred shares of Red Eye Airlines (hereinafter "Red Eye"). Stock tycoon, Gekko, trying to stop a mass exodus of investors from his broker's favorite airline, fraudulently and collusively orchestrates the issuance of an overly optimistic financial report to Red Eye shareholders. In fact, the financial report makes no mention of a recent \$100 million judgment rendered against Red Eye. Fox relies on the report and keeps stock that he would have sold had he known the truth. When news of the judgment hits newsstands a week later, the value of Red Eye stock plummets.

When Fox realizes that he has been duped, he brings a state class action securities fraud claim against Gekko and Red Eye to recover his loss. Since Fox is a holder, the court determines that under *Merrill Lynch*, his claim is preempted by federal securities law. Fox therefore brings the action under (federal) Rule 10b-5. However, the federal district court determines that Fox cannot proceed because, under *Blue Chip*, the plaintiff must have been a purchaser or seller, and Fox was neither. The result is that post-*Merrill Lynch* there can be no class action securities fraud claims by "holders." The Court's decision leaves those like Fox — holders whose relative stake in the suit's outcome makes it too risky or expensive to sue unless part of a class action — with no recourse.

Even considering Fox's predicament, and assuming securities regulation is necessary,¹³⁹ the Supreme Court made the right de-

136. *Merrill Lynch*, 126 S. Ct. at 1512.

137. *Id.*

138. *Id.*

139. It is widely accepted by economists that securities regulation is generally unnecessary. RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 198 (2nd Prtg. 1974). The extensive regulation of an otherwise free market was spurred by the 1929 stock market crash. *Id.* The idea was that sharply falling stock prices had caused the crash, so regulations were enacted to prevent such a crash from happening again. *Id.* Economists consider such reasoning a fallacy because they do not attribute the stock market crash to a precipitous fall in stock prices; instead they accredit it to an expected decline in economic activity. *Id.* The SEC regulations, which are supposed to increase the flow of information and therefore strengthen consumer confidence, are viewed by economists as nothing more than govern-

cision in *Merrill Lynch*. The Court's holdings in *Blue Chip* and *Merrill Lynch* relied on the policy-based idea that strike suits must be curbed.¹⁴⁰ If the Court in *Merrill Lynch* did not plug what was perceived to be the "holdings" claim exception to SLUSA, the aforementioned policy would have been left with a major leak.

The decision in *Blue Chip* (to adhere to the *Birnbaum* rule) was based on the "danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5."¹⁴¹ A major component of the aforementioned danger was the potential for strike suits.¹⁴² But the threat of strike suits did not die after *Blue Chip*.¹⁴³ Hence, the Reform Act was enacted, which imposed heightened requirements and related sanctions on class action securities fraud claims.¹⁴⁴ If the Court had held differently in *Merrill Lynch*, class action holder claims could proceed at the state level, and the Court's goal of deterring strike suits would be left unfulfilled.

Admittedly, the holding in *Merrill Lynch* creates an anomaly by defining "in connection with the purchase or sale of" differently than in *Blue Chip*. However, the Court's decision avoided creating an even greater anomaly. Consider the following plaintiff classes in relation to the holdings in *Blue Chip* and *Merrill Lynch*: (1) shareholders who were fraudulently induced not to buy; (2) shareholders who bought induced by fraud; (3) shareholders encouraged via fraud to hold onto overvalued stocks; and (4) shareholders who sold induced by fraud. Under the ruling in *Blue Chip*, only the shareholders in groups (2) and (4) have a federal cause of action under Rule 10b-5.¹⁴⁵ If the *Merrill Lynch* Court had accepted Dabit's argument, it would have allowed the holding in *Blue Chip* (which was meant to limit the plaintiffs who can bring a 10b-5 claim to groups (2) and (4)) to be used as an escape hatch through which "holdings" plaintiffs in group (3) could avoid being subjected to the *Blue Chip* decision. In other words, the Court in *Merrill Lynch* had to choose whether it would allow its decision in *Blue*

ment prodding in markets where information is already abundant due to free competition. *Id.*

140. *Merrill Lynch*, 126 S. Ct. at 1513-14; *Blue Chip*, 421 U.S. at 740-43.

141. *Blue Chip*, 421 U.S. at 740.

142. *Id.* at 740-43. See *supra* notes 113-118 and accompanying text.

143. *Merrill Lynch*, 126 S. Ct. at 1510. The courts had been seeing an influx of class action securities litigation characterized by "nuisance filings, [the] targeting of deep-pocket defendants, [and] vexatious discovery requests." *Id.* at 1510-11.

144. *Id.* at 1511.

145. *Blue Chip*, 421 U.S. at 755. The Court limited the cause of action under Rule 10b-5 to sellers and purchasers. *Id.*

Chip to be used by holders in order to avoid the *Blue Chip* holding or to completely extricate class action securities fraud claims brought by holders. The Court chose the latter in the name of curbing vexatious litigation.¹⁴⁶

In effect, the holding in *Merrill Lynch* was no more than judicial duct tape used to patch the effects of the admittedly arbitrary¹⁴⁷ yet policy-conscious rule ratified in *Blue Chip*. Perhaps the greatest irony in the eyes of a present-day defrauded class of securities holders with no recourse is the quiet reassurance of the *Blue Chip* majority, who explained that the disadvantages of the purchaser-seller rule would be alleviated to some extent because remedies were available to non-purchasers and non-sellers under state law.¹⁴⁸ It is fitting that the *Blue Chip* Court's reassurance was hidden in a footnote, because after *Merrill Lynch*, recourse for a defrauded class of holders under state law is no longer an option.

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146. *Merrill Lynch*, 126 S. Ct. at 1510.

147. *Blue Chip*, 421 U.S. at 738-39.

148. See *supra* note 110 and accompanying text.